FY 2003 Permanent Base Cuts:

A Crucial Step in Implementing the Balanced Budget Plan

A Report to

Governor Frank O'Bannon and Lieutenant Governor Joe Kernan

From

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With Assistance and Support

From

Each of the Administration's Agency Heads

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The Balanced Budget Plan

History

The O'Bannon-Kernan Balanced Budget Plan was announced November 15, 2001, by Governor O'Bannon in a televised address to the citizens of Indiana. His announcement was preceded by a revised revenue forecast for the state's General Fund, which was presented Nov. 14, 2001, by economic experts to the State Budget Committee. These experts predicted that revenues would contract by a negative 0.5 percent in FY 2002 and grow by 2.7 percent in FY 2003. These growth rates were in stark contrast to the growth rates that had been forecasted in April 2001, by 4.2 percent for FY 2002 and 4.6 percent for FY 2003.

The updated revenue forecast projects that the FY 2002-03 budget will end with a $1.3 billion deficit if nothing is done to affect it. Compared with an historical average growth rate of 5.25 percent, the projected growth rates for the current biennium – negative 0.5 percent and positive 2.7 percent – and actual revenue loss in FY 2001 of negative 1.0 percent are expected to cost the state General Fund $3.1 billion over a three-year period (FY2001 through FY2003). This reduction in revenues clearly shows the need for corrective action to be taken in the 2002 session if we are to properly address the state General Fund budget. Waiting for the 2003 session to act will mean the biennium would be almost over before any correction can be made. Further, waiting will create the need to raise more than $1.3 billion in new taxes after this fall's election, just to break even as we begin the process of developing a new budget for FY 2004 and FY 2005.

In Indiana' Fiscal Challenge, 2002: Choosing the Path to Recovery, Fiscal Policy Report No. 20, the independent Indiana Fiscal Policy Institute reached a similar conclusion:

> The state has lost $3.7 billion in expected revenue collections to the current recession and could lose more. The biennial budget is almost 2 billion dollars out of balance and the problem, absent intervention, becomes more unmanageable in the next biennium.

Goals

The O'Bannon-Kernan Balanced Budget Plan has two goals:

- Resolve the state's current budget deficit; and
- Maintain essential state services, especially K-12 funding.

Those goals have not changed since the announcement of the plan and are achieved in House Bill 1004 as passed by the Indiana House of Representatives.

What is a balanced budget?

The current biennial budget is out of balance. It has a structural deficit, which means that **revenues are inadequate to cover ongoing expenses.**

One of the easiest ways to understand why a balanced budget is important is to compare the state budget to a family budget. Here is an example:

- Assume there are two wage earners: one earning $30,000 and the other working part-time at $10,000 (for a total of $40,000/year), with a savings balance of $1,000, and ongoing expenses of $40,000 (mortgage, car payments, utilities, clothes, food).

- Now let's assume that either because the part-time worker is laid off or the full-time worker has to reduce hours of work, the family loses $10,000 worth of income in midyear. The family now has a budget deficit of $10,000.

- In the short-term, the family can try to cut back, delay payments and use up its savings just to make it through. But until that lost $10,000 in wages is replaced, the family will fall farther and farther behind. The payments that the family has delayed will have to be eventually made, and projects that are deferred will either have to be eliminated -- or completed at a later date. If something else bad happens, such as an unexpected illness, the need for a new furnace, or major car repair, the family will have no savings to rely on in dealing with that crisis.

The lesson to learn from this example is that until revenues (income) match expenditures (expenses), the budget crisis has not been solved. The additional lesson to learn is that it is unwise to deplete all reserves (savings) because then there is no way to deal with the unexpected, such as natural disasters like tornadoes and floods, or a terrorist act.

Spending cuts

Purpose of this document

The Balanced Budget Plan was designed to balance the General Fund budget by June 30, 2003, the close of the biennium, and to have it in balance for the next biennium as well. To achieve that goal, the plan provided for $782 million in both one-time and permanent base spending cuts, including $109 million in permanent base cuts in state government appropriations.

These permanent base cuts are listed by agency in Exhibit A, attached to this document.

Priorities in making cuts

In determining the $109 million in cuts, the Governor and Lieutenant Governor identified essential government services that should be protected – education, protection of vulnerable citizens, public safety and public accountability.

Following these priorities the State Budget Agency asked agencies to identify permanent base cuts for review by the Governor and Lieutenant Governor. While no agency or institution was considered immune from cuts, we have attempted to protect the performance of essential services wherever possible.

The four priority areas were shielded as much as possible because of their importance to the future, as well as the overall health and well being of the citizens of Indiana.

The targeted amount of $109 million in cuts could have more easily been accomplished by an across-the-board approach. However, this strategic, more thoughtful approach enables the state to reduce spending in areas considered important but non-essential and protect services that are essential to Hoosiers both immediately and in the future.

What the $109 million in cuts mean

- These are permanent cuts. The amounts that are subtracted from agency budgets will not be restored in the next budget cycle. Agencies will develop their budgets for the FY2004-05 biennium from the lower base that results from these permanent cuts.

- Hundreds of vacant funded positions in state general fund agencies are being eliminated. These positions are vacant, not because they are unnecessary but because the Governor froze hiring early in this fiscal year. What was previously frozen now becomes permanent, resulting in about 400 fewer positions on the state payroll.

- Personal services contracts will be cut by more than $11 million. Again, priority services will be protected, such as contracts for foster parents, meals on wheels, health insurance for all three branches of government, and educational services.

- These cuts will very likely cause the delay of many services, often beyond what citizens want.

- Because the State Budget Agency must protect essential services, like education, public safety, human services and government accountability, certain agencies will bear a greater burden than others.

- In the area of institutional care, the State of Indiana continues to move toward community-based care for children and adults, a higher-quality, lower-cost alternative. Some of the permanent cuts will occur because we are offering different service models for the benefit of our clients and patients.

When do these cuts have to be in place?

These cuts must be in place by July 1, 2002, just four and one-half months from now. Therefore, the administration must begin making these cuts now, in order to have them fully in effect for FY 2003, which runs from July 1 through June 30, 2003.

Do these cuts have to be included in HB 1004?

The State Budget Agency, through the allotment process, can make these cuts without legislative action. However, amendment of the 2001 Budget Act to show these reduced appropriations as “de-appropriations” would clearly indicate legislative support for these permanent base cuts.

What is on the horizon?

FY 2002 - 2003 reversions

As part of the Balanced Budget Plan, the State Budget Agency has already directed the reversion of at least $176 million for FY 2002. That means the agencies returned funds to the General Fund that had been **appropriated to their budgets but which had not yet been spent.**

For FY 2003, the plan requires $203 million in additional reversions **in addition to the $109 million in permanent base cuts discussed in this report**. As a result, more services – beyond those resulting from the $109 million in permanent cuts – will have to be reduced in the future.

Medicaid savings

As a corollary to the Balanced Budget Plan, the O'Bannon-Kernan Medicaid Savings Plan was announced Jan. 4, 2002. Without full implementation of the Medicaid Savings Plan, the Balanced Budget Plan will not achieve its goals. The state is facing an unknown additional burden to Medicaid as a result of the Day case, which has as much as $322 million in retroactive liability. As noted in "Indiana's Fiscal Challenge 2002:

> "Governor O'Bannon's Balanced Budget Plan is dependent for its success on cutting $250 million in projected Medicaid spending for the FY 2002 and FY 2003 biennium, which is over and above the legal appropriation. Many observers rate this an extremely difficult task."

If the full $250 million is not realized, additional cuts will have to be made.

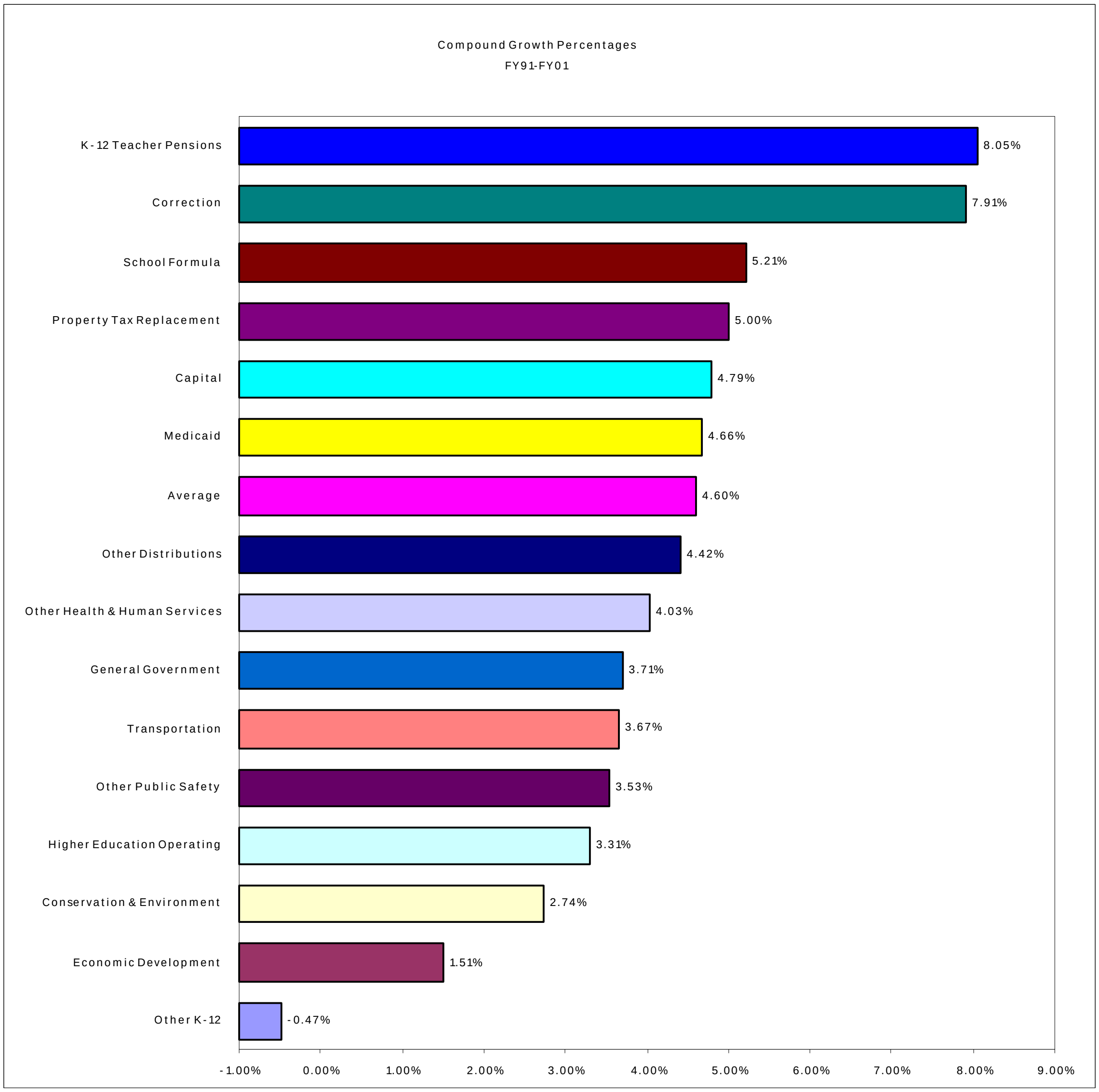
Additional revenue shortfalls

The Balanced Budget Plan is based on the November 2001 revenue projections. If actual revenues do not meet those projections, then the fiscal crisis worsens. For example, revenue was projected to be 0.5 percent lower in FY 2002 than in the previous year – a continuation of the negative growth we began to experience in 2001. Thus far, revenue **is not** achieving that projection; it is down a negative1 percent. If the revenue projections for FY 2002 or FY 2003, or both, do not meet expectations, additional cuts will have to be made.

Limiting growth

Areas of budget growth

The State Budget Agency analyzed the last 10 years of revenues and expenditures and identified the areas of largest percentage growth: These were in descending order:



We chose a 10-year period to reflect an economic cycle. Even if a six-year period is used, the areas of largest growth remain the same – teachers' retirement, property tax relief and prisons. These areas of largest percentage growth in expenditures are virtually non-discretionary. Areas of discretionary growth include education, where growth has exceeded the average.

Both Governor O'Bannon and his predecessor in office, Governor Bayh, believe that improvement in education funding is the best investment that can be made in Indiana's future.

The State Budget Agency will continue to impose spending constraints through the budget development process for the FY 2004-05 biennium. In compliance with the Balanced Budget Plan, total state expenditures will be held to an annual growth rate below 4 percent for FY 2004 and FY 2005.

This means that the next biennial budget will not permit restoration of the cuts that are made in the current biennium.

If the Balanced Budget Plan is not adopted

Reallocations and revenue enhancements

In addition to the permanent cuts, reversions and transfers that are discussed above, the Balance Budget Plan requires legislation to effect reallocations and revenue enhancement to address the **$800 million deficit that would remain** after the spending cuts**.** If the Balanced Budget Plan is not adopted by the Legislature, that $800 million will have to be offset by further cuts and use of short-term remedies, which do not address the structural deficit.

Payment delays

The Balanced Budget Plan anticipates that the payments that were delayed to public schools, universities and local units of government would be made up starting in FY 2005. However, without the plan, it is impossible to say when those delayed payments will be restored – if at all.

Impact on K-12

A recent bulletin issued by the Indiana School Boards Association, the Indiana Association of School Business Officials and the Indiana Association of Public School Superintendents discussed what would happen if the Balanced Budget Plan is not adopted by the legislature. If that occurs, public schools will be unable to transfer money from capital and other funds to offset $115 million in reduced tuition support. In describing a worse case scenario, these school groups observed that almost 2,900 full-time-equivalent teachers' positions would be lost to the school corporations across the state.

Impact on reserves

The Balanced Budget Plan is necessary to preserve the state's reserves:

- Medicaid reserve, to cover unanticipated expenditures;
- Tuition reserve, to provide protection for the payment of tuition support; and
- Rainy Day Fund

The Balanced Budget Plan holds the Medicaid Reserve and Tuition Reserve at current levels: $100 million and $265 million, respectively. It reduces the Rainy Day Fund from $525 million to $307 million.

Spending down the reserves

Some feel that the state should use its entire savings as a one-time fix rather than address the structural deficit. That would place the state in the same position as the family discussed earlier that spent its savings and has no money to pay for future emergency needs.

The Balanced Budget Plan provides a reserve of nearly 10 percent so that:

- If the experts are wrong and the economy does not perform as projected, the state has a cushion that enables us to pay our bills and continue essential services;
- If the state must pay as much as $322 million under the Day case, other Medicaid services will not have to be cut still further;
- Indiana's excellent bond rating will continue to keep interest rates low for the state, cities, towns, and counties, saving millions of taxpayers dollars; and
- We are able to respond to natural or other disasters.

Will revenue growth solve this problem?

No. The Governor and Lieutenant governor have repeatedly observed that the state cannot grow its way out of this budget crisis. Their point was reinforced by the "Indiana's Fiscal Challenge 2002" report:

> "If revenue growth exceeds the average rates contained in the governor's Balanced Budget Plan, then the need to raise taxes or find major spending cuts would be obviated. However, the magnitude of those revenue increases would have to be astounding. If the current revenue forecast – through FY 2003 -- proves accurate, then revenue in the next biennium would need to grow by 12.5% in the first year and 6.5% in the second year in order to maintain appropriations growth at the 3.3% per year projections contained in the Governor's Balanced Budget Plan proposal." [Emphasis added.]

At Indiana's highest peak of economic growth, revenues grew by 9.9 percent.

Other options

Numerous other suggestions have been made for addressing the deficit. Most, however, do not actually address the deficit. Most simply address the cash balance at the close of the next two fiscal years.

We must keep in mind that the deficit **is the difference between ongoing revenues and planned expenditures**. Even with the cuts included in the Governor's Balanced Budget Plan, revenues fall short of spending by an estimated $800 million.

Spending down the reserves is an option that addresses the cash balance and can be done once. Using other "pots of money" is an option that addresses the cash balance and can be done once. The sale of surplus property permits the deposit of cash into the General Fund. Once. Transfer of old capital accounts permits the reversion of money into the General Fund. Once.

Suggestions like these must be contemplated, but only as a last resort. Failure to address the deficit with real and meaningful long-term remedies forces Indiana to continue down a path of difficult choices that erode our quality of life and lend unnecessary uncertainty to our state's future.

Respectfully submitted,

Betty L. Cockrum, State Budget Director

Exhibit A: Permanent Base Cuts by Agency

Adjutant General: $835,547
- Cut administrative costs

Alcohol and Tobacco Commission: $308,407
- Eliminate positions
- Cut administrative costs

Board of Animal Health: $306,601
- Cut administrative costs

Civil Rights Commission: $196,864
- Cut administrative costs

Clean Manufacturing Technology and Safe Materials Institute: $33,250
- Cut administrative costs

Commission for Higher Education: $110,401
- Eliminate positions
- Cut administrative costs

Commission on Community Service and Volunteerism: $24,606
- Cut administrative costs

Commission for Proprietary Education: $33,689
- Cut administrative costs

Commission on Public Records: $130,745
- Eliminate positions

Court of Appeals: $142,598
- Judicial salary increases eliminated

Criminal Justice Institute: $886,870
- Delay state match payment

Department of Administration: $1,643,734
- Eliminate positions
- Cut administrative costs

Department of Commerce: $3,091,937
- Cut Small Business Development Corporation and Economic Development Council budgets
- Reduce Skills 2016 program grants
- Reduce Capital Access Program loans

Department of Correction: $16,511,451
- Eliminate positions
- Close Westville Transition Unit
- Close Wishard Detention Unit
- Cut administrative costs

Department of Environmental Management: $4,894,428
- Cut administrative costs

Department of Health: $5,283,002
- Eliminate vacancies
- Eliminate Hoosier State Games
- Cut administrative costs

Department of Insurance: $421,884
- Cut administrative costs

Department of Labor: $397,192
- Eliminate positions
- Cut administrative costs

Department of Local Government Finance: $636,101
- Eliminate positions
- Eliminate reassessment public awareness campaign
- Cut administrative costs

Department of Natural Resources: $8,251,660
- Eliminate positions
- Reduce intermittent workforce
- Close Wyandotte State Recreation Area swimming pool
- Close Bass Lake State Beach
- Eliminate DNR cultural arts program
- Eliminate special events at state parks and reservoirs
- Close some campgrounds, picnic areas, shelter houses
- Close Potato Creek State Park Horseman's Camp
- Close Spring Mill Twin Caves
- Close boat ramps on four reservoirs and one lake
- Reduce training

Department of Revenue: $3,820,000
- Cut administrative costs

Department of Transportation: $41,610
- Cut administrative costs

Education Employment Relations Board: $54,552
- Cut administrative costs

Ethics Commission: $19,234
- Reduce training

Family and Social Services Administration: $44,080,919
- Eliminate positions
- Reduce Step Ahead funding to counties
- Reduce Food Stamp program
- Transfer funding of Larue Carter Memorial Hospital School to local level
- Continue to slow expansion of Developmentally Disabled Client Services waiver program
- Continue to slow expansion of Community and Home Options to Institutional Care for the Elderly
- Eliminate Client Services for Physically Disabled program
- Cut administrative costs

Governor's Office: $211,014
- Eliminate positions
- Cut administrative costs

Historical Bureau: $31,376
- Cut administrative costs

Indiana Arts Commission: $276,469
- Reduce artist grant awards
- Cut administrative costs

Indiana Board of Tax Review: $105,037
- Eliminate positions
- Cut administrative costs

Indiana Department of Veterans' Affairs: $71,301
- Eliminate positions
- Cut administrative costs

Indiana Judicial Center: $1,000,000
- Eliminate funding for Probation Services program

Indiana Law Enforcement Training Academy: $389,474
- Reduce training courses
- Cut administrative costs

Indiana School for the Blind: $780,062
- Eliminate positions
- Cut administrative costs

Indiana School for the Deaf: $1,293,724
- Eliminate positions
- Cut administrative costs

Indiana State Police: $2,010,269
- Cut administrative costs

Indiana Veterans' Home: $1,070,522
- Eliminate positions
- Cut administrative costs

Indiana War Memorial Commission: $84,729
- Eliminate positions
- Reduce Civil War Museum hours

Information Technology Oversight Commission: $69,165
- Eliminate positions

Office of Environmental Adjudication: $23,067
- Cut administrative costs

Office of Lieutenant Governor: $230,401
- Eliminate positions
- Decrease agricultural grants
- Cut administrative costs

Professional Licensing Agency: $218,580
- Eliminate one position
- Cut administrative costs

Professional Standards Board: $256,404
- Discontinue teacher preparation program
- Cut administrative costs

Prosecuting Attorneys' Council: $42,700
- Eliminate positions

Public Access Counselor: $12,787
- Cut administrative costs

Public Defender Council: $55,613
- Eliminate positions
- Cut administrative costs

Public Defender's Office: $430,000
- Cut administrative costs

State Budget Agency: $184,532
- Eliminate positions
- Cut administrative costs

State Emergency Management: $340,452
- Eliminate Emergency Medical Services Equipment Incentive Grant program
- Cut administrative costs

State Library: $287,140
- Eliminate positions
- Cut administrative costs

State Personnel Department: $478,521
- Eliminate positions
- Eliminate funding for reclassifications

State Student Assistance Commission: $472,962
- Cut number of grants
- Cut administrative costs

State Workforce Development: $1,738,302
- Reduce worker training programs
- Reduce Skilled Credential Program
- Reduce workplace literacy program

St. Joseph River Basin Commission: $5,271
- Cut administrative costs

Supreme Court: $4,761,302
- Judicial salary increases eliminated

Tax Court: $9,507
- Judicial salary increases eliminated

White River State Park Commission: $170,043
- Cut administrative costs

Women's Commission: $8,456
- Cut administrative costs

Workers Compensation Board: $137,399
- Eliminate positions
- Cut administrative costs